ACCOUNTING FOR INTERNAL ACQUISITION COSTS

April 7, 1998

As the result of a March 19 decision made by the Emerging Issues Task Force ("EITF") of the Financial Accounting Standards Board ("FASB"), real estate companies must begin to expense the salaries and related costs of internal staff dedicated to identifying and acquiring property.

The ruling, 97-11, entitled "Accounting for Internal Costs Relating to Real Estate Property Acquisitions," provides that internal costs of identifying and acquiring operating property should be expensed as incurred. However, costs associated with the acquisition of non-operating property may still be capitalized (though any revenues derived from non-operating property are considered incidental and cannot be recognized in income).

Effective Date

This pronouncement is effective March 19, 1998. Internal acquisition costs beginning on that date forward must be expensed as incurred. NAREIT does not expect this decision to receive further deliberation by the EITF, or to be reversed in the foreseeable future.

Options for REITs That Capitalized These Costs

Following this change in accounting, real estate companies that have capitalized these costs have two alternatives: 1) continue to keep internal staff dedicated to the acquisition function and expense the associated costs of staff as a part of their general and administrative expenses; or 2) outsource the function to a wholly-independent third party and thereby continue to capitalize costs paid in the arrangement. Companies that currently outsource will continue to capitalize attendant costs so long as the arrangement is with a wholly-independent third party.

Going forward, factors likely to influence a real estate company's decision of whether these functions should be internally or externally executed may include the degree to which expensing adversely influences FFO, what works best with an individual company's business plan, and what becomes the common practice of most real estate companies. The determination should not alter the fundamental economics of an acquisition transaction or affect substantially a real estate company's ability to generate shareholder value over time.

Background

From beginning to end, NAREIT worked closely with the staff of the Financial Accounting Standards Board and members of the Emerging Issues Task Force as they deliberated this issue. Initially, the issue was raised by an EITF representative from an audit firm looking for clarification of which internal acquisition costs should be capitalized-direct and indirect costs, or only direct costs. This matter was preliminarily resolved with the EITF and NAREIT in agreement that only direct costs should be capitalized. However, the Securities and Exchange Commission later strongly asserted that a business acquisitions analogy is better suited to real estate acquisitions. That view ultimately formed the basis for the EITF's final decision to expense internal acquisition costs.

NAREIT disagrees with this particular decision in part because it establishes a wide variance in accounting for costs associated with internal staff versus outside consultants.

Trend in REIT Reporting

With significant growth in the REIT and public real estate industry, it's no surprise that financial reporting practices that apply to real estate companies are under greater scrutiny by outsiders looking in. Some of these interests would like to change accounting for real estate companies in a way that eliminates real estate's accounting distinctions from the traditional business reporting model. Over time, this viewpoint is likely to bring real estate and general business accounting closer together.

NAREIT's experience working with the SEC, FASB, and the American Institute of Certified Public Accountants has proven that when accounting differences and exceptions are proposed exclusively for real estate companies, the industry is faced with a high hurdle to demonstrate the rationale for a position specific to the real estate industry. A good example of such a hurdle is our ongoing effort to establish funds from operations as a performance benchmark under generally accepted accounting principles. The possibility that this matter could have been deliberated and resolved within the industry underscores the importance of NAREIT's newly organized task force on best financial practices. Through this group, future diversity in practice issues will be discussed, initially resolved and then forwarded to regulators for consideration.

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